Observations On The Gold/Silver Ratio

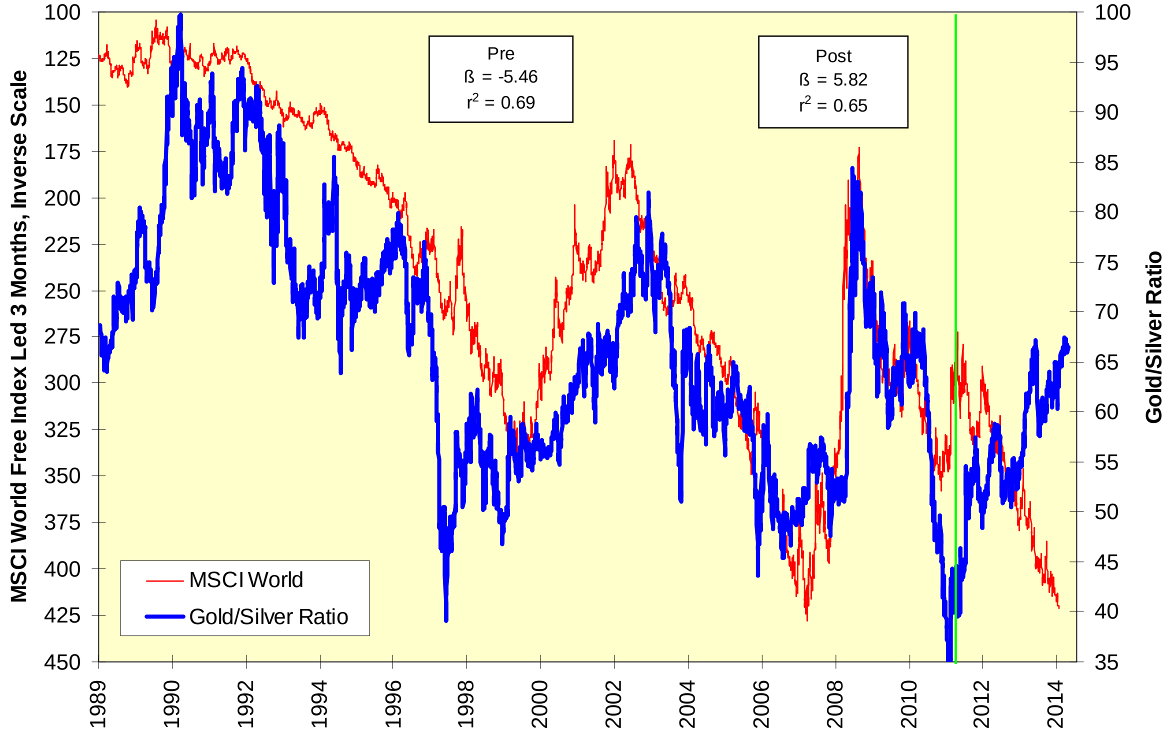
When Thomas Jefferson or whoever the final draftsman of the Declaration of Independence actually was (John Adams, Ben Franklin, Robert Livingston and Roger Sherman all participated) penned the words, “Prudence, indeed, will dictate that Governments long established should not be changed for light and transient causes,” he very might have been talking about intermarket analyses.

Here is a truth I hold to be self-evident: Markets with an inverse relationship extending back for more than two decades should not shift to a direct relationship without a compelling reason.

Twist This

I am talking, of course, about the relationship of the gold/silver ratio (GSR) to the MSCI-Barra World Free index. The GSR leads the World index by three months on average. Great, you shrug. Stop shrugging. Between January 1989 and the beginning of the Federal Reserve’s Operation Twist in August 2011, this was an inverse relationship with a beta of -5.46 and an r-squared or percentage of variance explained of 0.69. After the Twist, the r-squared remained a similar 0.65 but the beta reversed to 5.82.

The World Equity-GSR Relationship Reversed After Twist Began

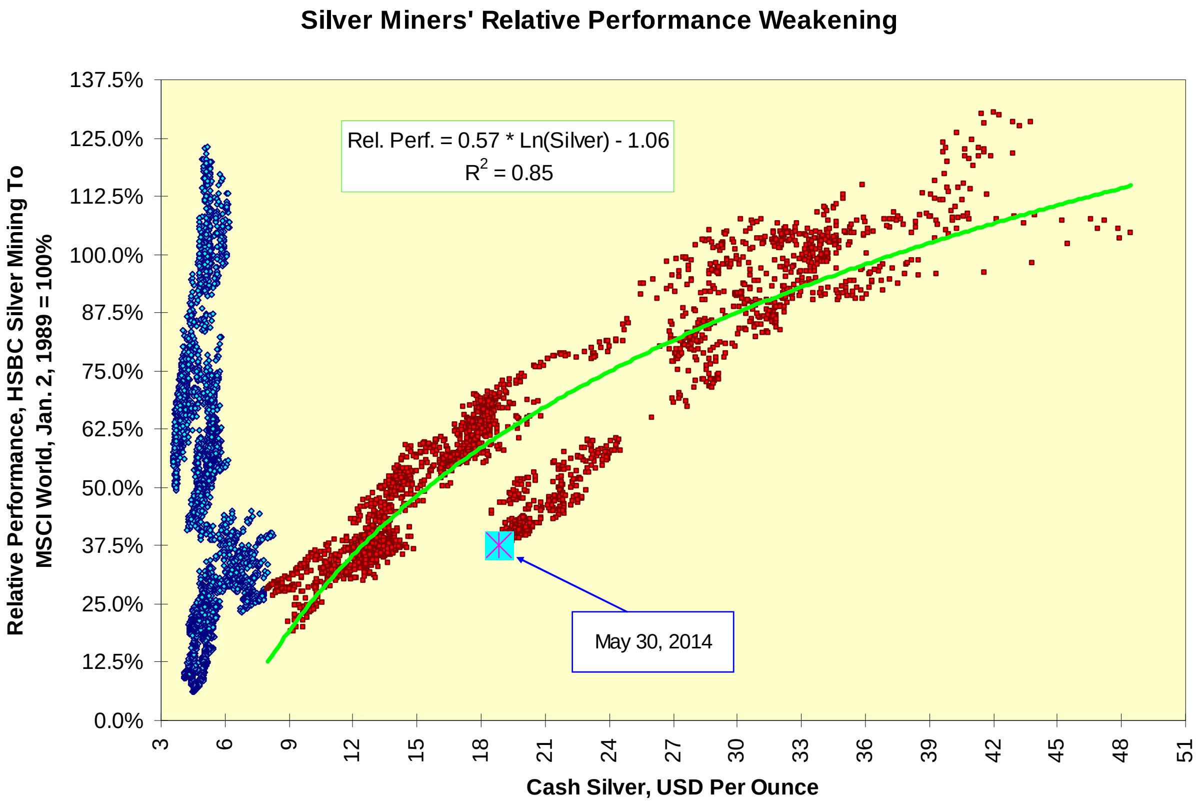


I noted in December 2013 how the Twist was very negative for gold as the artificial bullish flattening of the yield curve encouraged investors to shift out on the yield curve into high-yield bonds, equities and other risky financial assets. As the Twist helped arrest some of the economic uncertainty swirling about in 2011, it tended to support silver vis-à-vis gold and led to the continued decline in the GSR.

If and when the Federal Reserve and its sister central banks cease and desist with their monetary manipulations, a statement and not a forecast, I would expect the old inverse relationship between the GSR and global equities to return.

Trying To Find Gold In A Silver Mine

If silver had suffered less than gold during the Twist era, you would not know it from the relative performance of the HSBC Silver Mining index to the MSCI-Barra World index as a function of silver prices. The relationship prior to November 2005 had been a random one. I marked these points in blue. The post-November 2005 history, marked in red, was logarithmic, suggesting relative performance declined as silver prices increased. This is a typical pattern for resource producers and reflects an embedded short call option on silver in reflection of its rising risk at higher prices.



That relative performance has been very weak of late as investors have decided to stop gambling on silver miners when higher-yielding plays not dependent on the price of a commodity are available.

Once again, I would expect this to change if and when all of the meddling stops. However, as I do not expect the meddling to stop anytime soon, I do not expect silver miners to be worth your time and effort.